

Message Text

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C O N F I D E N T I A L SECTION 1 OF 3 TEL AVIV 7144

Z.O. 11652: GDS
TAGS: EGEN, IS
SUBJECT: ISRAEL'S ECONOMY AFTER A YEAR UNDER THE LIKUD

1. SUMMARY. AFTER A YEAR OF THE MARKET-ORIENTED ECONOMIC
POLICIES OF THE LIKUD GOVERNMENT, THE ISRAELI ECONOMY
DOES NOT LOOK MUCH DIFFERENT THAN IT WOULD HAVE UNDER
LABOR. THERE HAS BEEN WIDE PUBLIC ACCEPTANCE OF THE
IDEA OF LESS GOVERNMENT INTERFERENCE IN THE ECONOMY
AND MORE PRIVATE INITIATIVE. IDENTIFIABLE EXAMPLES
OF THIS HAVING OCCURRED HOWEVER, ARE FEW. GOI ACHIEVEMENTS
IN OTHER ECONOMIC AREAS HAVE BEEN SPOTTY:

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THE BALANCE OF PAYMENTS IS MUCHIMPROVED AND ECONOMIC
GROWTH IN 1978 MAY REACH 6 PERCENT (COMPARED TO ALMOST
NO GROWTH IN THE PREVIOUS THREE YEARS); HOWEVER,
INFLATION COULD REACH 40 PERCENT, BECAUSE OF A HUGE
BUDGET DEFICIT; SAVINGS AND INVESTMENT IN PRODUCTIVE
ACTIVITY WILL BE BELOW GOI TARGETS AND PRIVATE CONSUMPTION
WILL CONTINUE TO RISE. BECAUSE OF PUBLIC

PREOCCUPATION WITH THE PEACE PROCESS, THE GOVERNMENT HAS RECEIVED LESS CRITICISM OF ITS ECONOMIC POLICY THAN WOULD ORDINARILY HAVE BEEN THE CASE. THERE ARE RUMBLINGS FROM PORTIONS OF ORGANIZED LABOR AND SOME HERUT BACK-BENCHERS, WHO REPRESENT THE COUNTRY'S POOREST JEWS, THAT THIS IS A RICH MAN'S GOVERNMENT. NEVERTHELESS, IT WILL BE THE LIKUD'S PERFORMANCE IN THE PEACE NEGOTIATIONS RATHER THAN ITS ECONOMIC POLICY WHICH WILL BE THE YARDSTICK OF JUDGEMENT USED BY MOST ISRAELIS IN THE MONTHS AHEAD. END SUMMARY.

2. PHILOSOPHY

THE LIKUD GOVERNMENT HAS SUCCEEDED IN CHANGING THE PREVAILING ECONOMIC PHILOSOPHY IN ISRAEL TOWARDS THE MARKET ECONOMY APPROACH. ALTHOUGH CONCRETE EXAMPLES OF SHIFTS TOWARD THE PRIVATE SECTOR AND REDUCTIONS OF GOVERNMENT INFLUENCE IN THE ECONOMY ARE FEW (THE MAJOR EXCEPTION BEING THE REMOVAL OF MOST FOREIGN EXCHANGE CONTROLS LAST OCTOBER), THE GENERAL PUBLIC ATTITUDE IS DIFFERENT. THE MOST ENTHUSIASTIC SUPPORTERS OF THIS NEW "LIBERALISM" QUITE NATURALLY ARE IN THE BUSINESS SECTOR. THE GOVERNMENT CAN TAKE SATISFACTION, HOWEVER, THAT IT HAS ATTRACTED A MUCH WIDER BASE OF PUBLIC SUPPORT: THERE HAS BEEN LITTLE OUTCRY AND EVEN SOME SUPPORT FROM THE MAJORITY OF ISRAELIS IN THE FACE OF CONSUMER SUBSIDY CUTS AND INCREASES

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IN PUBLIC SERVICES CHARGES. CHIEF OPPOSITION TO THE NEW POLICIES HAS COME FROM ORGANIZED LABOR AND SOME MEMBERS OF HERUT, WHICH RELIES HEAVILY ON LOWER INCOME GROUPS FOR ITS POLITICAL BASE.

3. GOVERNMENT ORGANIZATION AND COORDINATION

THE LIEBERAL PARTY HAS ALMOST EXCLUSIVE CONTROL OVER ECONOMIC POLICY. THE PRIME MINISTER HAS NEITHER ANY UNDERSTANDING NOR INTEREST IN ECONOMIC MATTERS. THIS CAUSES SOME COALITION MEMBERS REAL ANXIETY BECAUSE THEY BELIEVE THAT IMPORTANT POLITICAL CONSIDERATIONS ARE BEING NEGLECTED. THEY SAY THE PUBLIC DISSATISFACTION WITH THE ALIGNMENT'S HANDLING OF ECONOMIC/SOCIAL MATTERS WAS THE REASON FOR ITS 1977 ELECTION DEFEAT AND THAT THE LIKUD IS FALLING INTO THE SAME TRAP. ON THE OPERATIONAL SIDE, VERY LITTLE HAS CHANGED FROM THE PREVIOUS ADMINISTRATION. THE CIVIL SERVICE STAFF IN MOST OF THE ECONOMIC MINISTRIES WERE RETAINED AND ONLY A FEW TOP OFFICIALS CHANGED. COORDINATION AMONG THE KEY ECONOMIC AGENCIES SUCH AS THE FINANCE MINISTRY, THE MINISTRY OF INDUSTRY, TRADE AND TOURISM, THE CENTRAL BANK AND KNESSET COMMITTEES IS STILL POOR -- JUST AS

IT HAS BEEN IN THE PAST. GOVERNMENT EXPENDITURE CONTROL AND TAX COLLECTION IS A MESS, AND THERE IS LITTLE PROSPECT FOR EARLY IMPROVEMENT. THE PRESENT GOVERNMENT DID NOT CREATE THIS SITUATION: MOST OF IT WAS INHERITED. THE LIKUD HAS DISCOVERED, HOWEVER, THAT CAMPAIGN PROMISES TO CLEAN THIS AEGEAN STABLE CANNOT BE FULFILLED AND REDUCTIONS IN THE TOTAL NUMBER OF CIVIL SERVANTS ON THE GOVERNMENT PAYROLL ARE NOT POSSIBLE. NO GOVERNMENT BUSINESSES HAVE BEEN SOLD SO FAR AND ONLY ONE SALE (A BANK) IS BEING MUCH DISCUSSED.

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4. POLICY ISSUES

A. BALANCE OF PAYMENTS. UNTIL RECENTLY, IMPROVEMENT IN THE BALANCE OF PAYMENTS HAS HAD FIRST PRIORITY IN THE NEW GOVERNMENT'S ECONOMIC POLICY. THIS PICTURE HAS IMPROVED ENORMOUSLY, TO THE GOI'S SATISFACTION, ALTHOUGH MUCH OF THE SUCCESS IS NOT DIRECTLY ATTRIBUTABLE TO PRESENT GOVERNMENT POLICIES. EXPORTS ROSE RAPIDLY

IN 1976 AND EARLY 1977. THIS HAS CONTINUED SINCE THE ECONOMIC MEASURES OF OCTOBER 1977. AS A RESULT OF STRONG SHOWINGS IN THE SERVICE AND CAPITAL SECTORS OF THE BOP, THE GOVERNMENT IS NOW HAVING TO TAKE ACTIONS TO AVOID THE EMBARRASSMENT OF TOO GREAT A
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RISE IN FOREIGN EXCHANGE RESERVES.

B. INFLATION. BECAUSE OF THE ABOVE, GOI ATTENTION HAS BEGUN TO FOCUS MORE ON REDUCTION OF THE COUNTRY'S EXTREMELY HIGH INFLATION RATE. THIS WILL BE A VERY DIFFICULT NUT TO CRACK IN THE SHORT AND LONGER TERMS. A COMBINATION OF COST-PUSH ELEMENTS (SUCH AS HIGHER PRICES FOR IMPORTS, DEPRECIATION OF THE POUND AND HIGHER CAPITAL COSTS) AND SOME EMERGING DEMAND-PULL FACTORS LEAD US TO BELIEVE THAT THERE WILL BE LITTLE IMPROVEMENT IN 1978 OVER THE 42.5 PERCENT RISE IN THE CONSUMER PRICE INDEX DURING 1977. THE GOI IS STILL TALKING IN TERMS OF 30-33 PERCENT, BUT WE ARE SURE THEY WOULD SETTLE GLADLY FOR 35 PERCENT NOW IF THAT COULD BE GUARANTEED. CENTRAL GOVERNMENT BUDGETARY DEFICIT REMAINS AN IMPORTANT, ALTHOUGH NOT THE ONLY, CAUSE OF INFLATION, AND THERE IS LITTLE PROSPECT THAT THE SITUATION WILL GET MUCH BETTER ANYTIME SOON.

C. WAGE POLICY AND EMPLOYMENT. LIBERAL PARTY PURISTS ARE COMMITTED TO THE CONCEPT THAT ORGANIZED LABOR HAS TOO MUCH ECONOMIC POWER IN ISRAEL AND SHOULD HAVE ITS WINGS CLIPPED. THEY ALSO WANT TO SEE WAGES IN THE PUBLIC SECTOR RESTRAINED WHILE THOSE IN THE EXPORT SECTOR GROW AS AN INCENTIVE FOR RESOURCE TRANSFERS TO MORE "PRODUCTIVE" ACTIVITIES. THEY PLANNED FOR THE OVERALL WAGE BILL TO REMAIN AT SOMETHING LIKE THE AVERAGE 1976 LEVEL. THE FACTS AFTER A YEAR ARE QUITE DIFFERENT: REAL WAGES ARE RISING IN ALMOST ALL AREAS; MINISTER OF FINANCE EHRICH AND HISTADRUT CHIEF MESHEL HAVE AVOIDED SERIOUS CONFRONTATION BY THE GOI AGREEING TO RATHER GENEROUS WAGE SETTLEMENTS AND LABOR ACCEPTING LESS THAN THE MAXIMUM GOALS (BOTH HAVE CONCLUDED THAT THE MARGINAL GAINS THEY
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MIGHT WIN IN A BITTER BATTLE ARE NOT WORTH THE RISKS); AND THE PUBLIC SECTOR IS FAR FROM WITHERING AWAY. SOME ADDITIONAL RESOURCES ARE FLOWING INTO EXPORTS, BUT IT IS UNCERTAIN WHETHER GOVERNMENT POLICIES HAVE

FACILITATED THIS. CRITICS OF "THE NEW ECONOMIC POLICY" CLAIM THAT EXPORT INCENTIVES HAVE IN FACT DECLINED SINCE THE ISRAELI POUND WAS FLOATED. UNEMPLOYMENT HAS CREPT UP SLIGHTLY TO NEARLY 4 PERCENT IN THE PAST YEAR (FULL EMPLOYMENT PROBABLY IS DEFINED AS ABOUT 3.5 PERCENT UNEMPLOYED HERE), BUT THIS MAY AGAIN BE ON THE DECLINE.

D. GROWTH. SINCE 1974 ISRAEL HAS HAD HIGH INFLATION AND A STAGNANT ECONOMY. THIS SITUATION NOW SEEMS TO BE CHANGING ON THE GROWTH SIDE - IN PART DUE TO DELIBERATE POLICIES AND IN PART BY ACCIDENT. RECENT ESTIMATES ARE THAT REAL GNP GROWTH FOR 1978 MAY REACH 6 PERCENT (THE GOI TARGET WAS 4-5 PERCENT). THE EXPORT BOOM, A REVIVAL OF THE CONSTRUCTION INDUSTRY AND STRONG RETAIL SALES (UP 6 PERCENT IN THE PAST QUARTER) ARE THE MAJOR FACTORS. THE LATTER TWO ARE RELATED TO THE RISE IN REAL WAGES UNDER THE LIKUD- AND UNINTENDED OCCURRENCE. THE RUB, OF COURSE, IS THAT THIS GROWTH LEVEL, WHICH THE IMPROVED BOP WILL SUPPORT, ALSO ADDS TO INFLATION.

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E. THE BUDGET. ALL OF THESE DEVELOPMENTS ARE AFFECTED BY AND AFFECT THE GOVERNMENT BUDGET. IN THIS AREA THE GOI HAS CUT A SAD FIGURE. BECAUSE DEFENSE AND DEBT SERVICE ACCOUNT FOR OVER 60 PERCENT OF THE TOTAL BUDGET AND NEARLY ALL OF THE REMAINDER IS REQUIRED BY LAW, TRULY DISCRETIONARY EXPENDITURES PROBABLY ARE LESS THAN 5 PERCENT. SINCE NO SIGNIFICANT IMPROVEMENTS ON THE REVENUE SIDE ARE PRESENTLY IN THE CARDS, ANY NEW GOVERNMENT PROGRAMS ONLY INCREASE THE ALREADY GROWING DEFICIT. RELUCTANCE OF THE FINANCE MINISTER TO AGREE TO THESE PROGRAMS HAS LED TO CHARGES FROM BOTH SIDES OF THE AISLE THAT THE GOVERNMENT

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HAS RENEGED ON ITS ELECTION PROMISES IN THE SOCIAL AREAS. ATTACKS HAVE ALSO COME FROM THE CENTRAL BANK HEAD AND LOCAL ECONOMISTS THAT THE GOI'S PRIORITIES ARE ALL WRONG IN THAT IT IS INFLATIONARY AND FAVORS CONSUMPTION WHILE DISCOURAGING INVESTMENT (LABOR GOVERNMENTS HEARD SIMILAR CRITICISMS). DESPITE TALK OF PENDING BUDGET DEFICIT "REDUCTIONS," WHAT WILL REALLY HAPPEN OVER THE REST OF THE BUDGET YEAR IS THAT EFFORTS WILL BE MADE TO KEEP THE DEFICIT FROM BALLOONING AS MUCH AS IT WILL IF NO ACTION IS TAKEN TO CUT BACK SOMEWHERE. ONE OR MORE SUPPLEMENTAL BUDGETS WILL BE NEEDED DURING THE PRESENT FISCAL YEAR TO COVER ACTUAL GOVERNMENT SPENDING.

F. SAVINGS AND INVESTMENT. THE GROSS INVESTMENT RATE IN ISRAEL DROPPED FROM APPROXIMATELY 39 PERCENT IN 1973 TO 28 PERCENT IN 1977. ALTHOUGH THE LATTER RATE IS STILL QUITE RESPECTABLE, THE GOI CONCERN IS THAT ITS CONTINUATION WILL MAKE IMPOSSIBLE A RETURN TO THE 8-10 PERCENT ANNUAL GROWTH RATES THE COUNTRY HAS ENJOYED DURING MUCH OF ITS HISTORY. THERE IS SOME RECENT EVIDENCE THAT INVESTMENT IS AGAIN RISING AS CONSTRUCTION HAS REVIVED. THIS IS NOT "PRODUCTIVE" INVESTMENT, HOWEVER, AND CONSUMPTION REMAINS HIGH. THE PRESENT GOVERNMENT TACTICS IS THAT ADDITIONAL SAVINGS AND INVESTMENT SHOULD BE FINANCED FROM A REVIVAL OF GNP GROWTH. LIKUD POLICIES HAVE NOT CAUSED CAPITAL TO FLOW INTO OR OUT OF THE COUNTRY IN LARGE AMOUNTS.

5. CONCLUSION.

ISRAEL'S MAIN MACRO INDICATORS ARE PROBABLY NOT SIGNIFICANTLY DIFFERENT AFTER A YEAR OF LIKUD GOVERNMENT THAN THEY WOULD HAVE BEEN HAD THE LABOR

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ALIGNMENT REMAINED IN OFFICE. ALTHOUGH THERE HAS BEEN A CHANGE IN ECONOMIC PSYCHOLOGY, AND THIS CHANGE SEEMS TO HAVE WIDESPREAD PUBLIC SUPPORT, THE BASIC ECONOMIC RULES OF THE GAME REMAIN ESSENTIALLY THE SAME. FINANCE MINISTER EHRLICH, WHO IS FIRST AND FOREMOST A CLEVER POLITICIAN, HAS NOT LET LIBERAL PARTY DOGMA GET IN THE WAY OF POLITICAL REALITY. A PRIME EXAMPLE WAS HIS DECISION TO PAY A HIGH PRICE FOR A TRUCE WITH LABOR LASTING THROUGH SEPTEMBER. HIS CALCULATION WAS THAT THE POLITICAL AND ECONOMIC COSTS OF STRIFE IN THE PUBLIC SECTOR DURING THE SUMMER WOULD BE EVEN GREATER. HE HAS UNDOUBTEDLY BENEFITED IN PURSUING HIS POLICIES FROM THE PUBLIC PREOCCUPATION WITH THE PEACE PROCESS. THAT IS STILL THE ISSUE ON WHICH THE LIKUD COALITION IS BEING JUDGED BY MOST ISRAELIS. IT IS LIKELY TO REMAIN SO IN THE MONTHS AHEAD. HOWEVER, SHOULD PEACE NEGOTIATIONS COME TO A HALT, ARGUMENTS OVER ECONOMIC AND SOCIAL POLICIES (WHICH UNTIL NOW HAVE BEEN LARGELY BUBBLING BENEATH THE SURFACE) WOULD BE AN IMPORTANT COMPONENT IN A POSSIBLE REALIGNMENT OF POLITICAL FORCES.

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